The New Yacht Club

The United States has not enjoyed a surge of new wealth to rival today's since the days when people read by gaslight, yet that era holds valuable lessons about the hazards of new fortunes.

BY STEVEN LAGERFELD

Jay Gould, the wealthiest man in America, was only 56 years old when he died in 1892, and the general opinion was that he had already lived too long. "So far as his life and career made him conspicuous he was an incarnation of cupidity and sordidness," declared *The New York World*. The *Herald* reported that there was "much quiet rejoicing" on Wall Street. *The New York Times* weighed in with a relatively measured judgment: "It is in our time that the 'operator' has been born, and JAY GOULD was an operator pure and simple, although, in a general way of speaking, he was as far as possible from pure and as far as possible from simple."

To the long list of things they don't need to worry about, the two wealthiest men in America, Bill Gates and Warren Buffett, can add what the obituary writers will say about them. Buffett, whose $46 billion leaves him in second place to Gates, with $53 billion, on the *Forbes* magazine list of the wealthiest Americans, hasn't even had to die to be dubbed the Sage of Omaha, as if investing were akin to Zen Buddhism. Beneath them, the rich and the merely affluent, with their mortgaged McMansions and leased Range Rovers, are admired (or at least ogled), rather than vilified as they were in Gould's day. Americans dwell so lovingly on the trappings of wealth that Tom Wolfe has invented a term to describe the new media genre that serves the taste, *plutography*. A yacht maker recently advertised a $20 million craft in *The Financial Times* as if it had the same mass appeal as one of Ron Popeil's Dial-o-Matic vegetable slicers.

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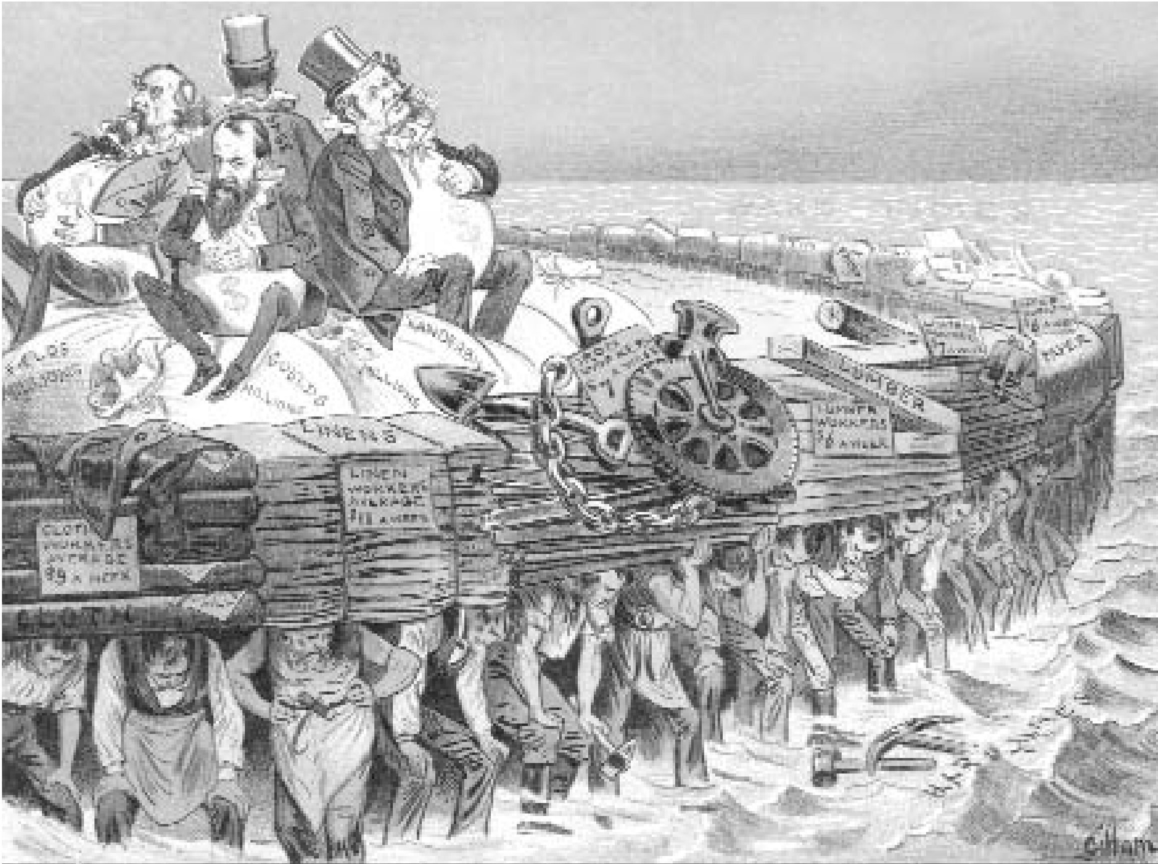
According to Emmanuel Saez, an economist at the University of California, Berkeley, who, with various colleagues, has done pioneering research on the history of American wealth and income in recent years, the top one percent of households in the United States increased its share of the nation's pretax wage and salary income from the post-World War II nadir of under eight percent in 1973 to 16 percent in 2004 (see chart, p. 41). During that period, the top 0.1 percent—about 130,000 households—increased their take from less than 2 percent to almost 7 percent. (Average income per household was nearly $5 million.) Such levels haven't been seen in many decades.

Americans' enthusiastic embrace of business and the rich represents an amazing change in public attitudes, and one does not need to look back a century to appreciate its magnitude. In the 1960s and '70s, business was deeply unpopular and corporations were thought to embody the soul-deadening conformity and materialism of American society. Liberals viewed the corporation as an antagonist and the affluent as milk cows for the wel-



Unlike today's benign information age capitalism, the late-19th-century version looked to many critics like a zero-sum game: Capitalists win, workers lose. In this 1883 cartoon, Jay Gould (center) sits with fellow "robber barons" Cyrus Field (left) and Cornelius Vanderbilt (right).

fare state. When President Ronald Reagan campaigned in 1981 to reduce tax rates on the rich (and others), howls of egalitarian outrage greeted a bill that ultimately reduced the top rate from 70 percent to 50 percent. Yet returning tax rates to that level now, much less to pre-Reagan levels, even after decades of rising income inequality, seems more unlikely than cutting them did then. Some leaders of the new Democratic majority in Congress have declared that reducing income inequality is a top priority, but their agenda as revealed so far has been mostly modest, stressing traditional measures designed to improve equality of opportunity, including increased aid and lower-interest loans for college students. Many Democrats would like to let some of President George W. Bush's tax cuts expire in 2010, raising top income tax rates, for example, from 35 percent to the 39.6 percent prevailing during the Clinton era. These are politically contentious proposals, but they are not soak-the-rich measures.

What accounts for this change in attitudes? The economic trials that beset the United States in the 1970s bred a renewed appreciation of the fragility of the nation's extraordinary wealth and the capitalist processes that create it. And Americans' deep-rooted willingness to accept that others are getting ahead as long as they and their children have the opportunity to do the same reasserted itself. But no embrace is unconditional, and there are already signs that the public's ardor for the new era of riches is flagging. The economic progress of many people on the middle and bottom rungs of the economic ladder—even allowing for understatement by some statistical indicators—is slow or nonexistent. Getting ahead is getting harder, as the costs of health care and a college education continue to rise faster than the rate of infla-

tion, and the ordinary insecurities of life on the job are magnified by the stresses of globalization, outsourcing, and technological change. Americans nurture the belief that their sons or daughters could start the next Google or make partner at a major law firm, but the world of the rich looks increasingly distant and alien as news of big-money finagling and lawbreaking arrives in the morning paper. And what about the children of the rich? Will they face anything like the challenges that others do in making their way in a competitive world, or will their parents' money buy them not only comfort but instant access to the top?

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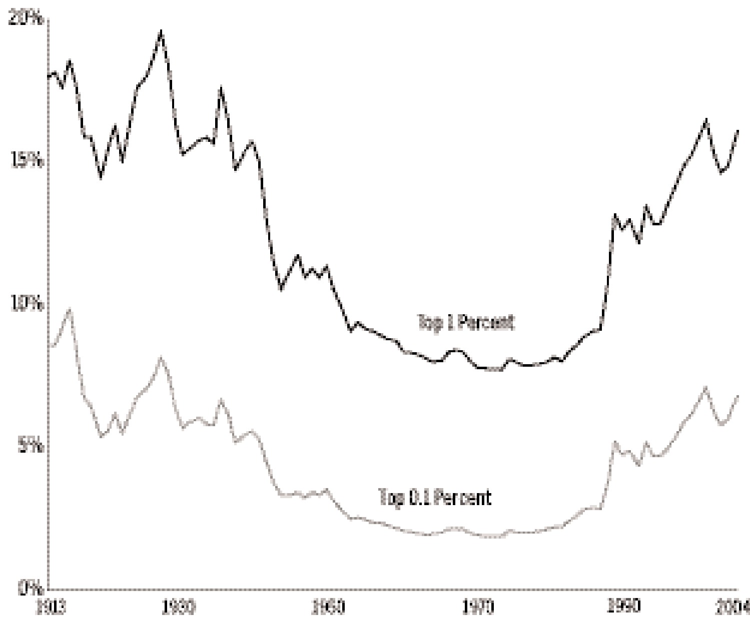
There has not been a period of sustained economic upheaval like today's information age revolution since the industrial transformation of Jay Gould's day suddenly created massive new manufacturing industries, and massive new personal fortunes to go with them. Gould and many of his contemporaries offer examples of what not to do in such a situation. Four years after he died, with the country in the grip of a severe economic depression, the populist William Jennings Bryan won the Democratic presidential nomination and led a crusade against the nation's moneyed interests and the politicians they owned. Bryan lost badly, but the reform impulse ultimately prevailed. Progressives created new regulatory agencies to rein in the freewheeling trusts and corporations. In 1913, reformers won a constitutional amendment allowing the federal government to impose an income tax. By 1918, when the nation was at war, America's wealthiest were subject to a top rate of 77 percent, more than double today's highest levy, and after dipping in the 1920s, the top rate was sustained at similarly punishing levels for decades. The 19th-century rich were creators and beneficiaries of a massive economic change who, paradoxically, resisted change and had it thrust upon them. So if one were to derive from this history some guidelines for the rich, Rule #1 might be *Don't Reflexively Resist Change.* There are others:

Rule #2: Share the Wealth. Charitable efforts, such as the Gates-Buffett joint venture in megaphilanthropy, announced when Buffett gave $31 billion to the Gates Foundation last year, are important, but they are not the most significant way that wealth is shared. Jay Gould's few known acts of philanthropy were roundly criticized as inadequate, and he didn't leave a dime to anybody outside his family. But Andrew Carnegie, John D. Rockefeller, and many other Gould contemporaries were well known for their giving. It mattered much more that in the hands of these men capitalism often appeared to be a zero-sum game: If I gain, you lose.

Gould again offers the dramatic illustration. He made his initial fortune as a Wall Street speculator renowned for ruthlessly manipulating markets, wiping out other investors large and small, and even causing a financial panic in one infamous attempt in 1869 to corner the gold market. While the mass of ordinary workers benefited immensely from the rise of 19th-century industrial capitalism, it was a hard climb, and the great industrialists often played the labor-management game like Gould played the market.

Whatever their sins, today's information economy billionaires are not seen as zero-sum entrepreneurs. In their rise to riches, great innovators such as Gates and Michael Dell minted millionaires out of ordinary office workers as well as top executives, and they created thousands of high-paying jobs as well as products that have transformed daily life. Their stories affirm the American faith in the possibilities of upward mobility. We see them as the proverbial geese laying golden eggs. But avoiding zero-sum situations may sometimes require weighing short-term economic gains from strategies such as outsourcing against more fundamental concerns. Even 19th-century capitalists sometimes made

Income Shares of the Highest Earners



Left: **While incomes are higher for all Americans, those at the very top of the scale have claimed a growing share of pretax income since the early 1970s. The top 0.1 percent (gray line) represents some 130,000 households.**

Middle: **America provides much opportunity to move up (or down) the income scale. More than 12 percent of the households in the middle-income quintile in 1988 rose to the top quintile 10 years later.**

Bottom: **One explanation for the income gap between the top and bottom quintiles is demographic: The top quintile includes many households with two working spouses.**

Mobility, Up and Down

The Distribution of Income
(Income Shares by Quintile, 2005)

Quintile	Share	Income range
Richest quintile	50.4%	$91,705 plus
Fourth quintile	23.0%	$57,658–$91,704
Third quintile	14.6%	$36,000–$57,657
Second quintile	8.6%	$19,178–$35,999
Poorest quintile	3.4%	$0–$19,177

Sources: *Top*, Emmanuel Saez, Top fractiles income shares (excluding capital gains) in the U.S., 1913–2004, "Income Inequality in the United States, 1913–1998," with Thomas Piketty, *Quarterly Journal of Economics*, vol. 118, no. 1 (2003), 1–39 (tables and figures updated to 2004, September 2006 at http://elsa.berkeley.edu/~saez/). *Middle*, "Are Lifetime Incomes Growing More Unequal? Looking at New Evidence on Family Income Mobility," with Katharine Bradbury and Jane Katz. Federal Reserve Bank of Boston, *Regional Review*, vol. 12, no. 4 (Quarter 4, 2002). *Bottom*, U.S. Census Bureau.

sacrifices for the communities they inhabited.

Rule #3: Play by the Rules. Jay Gould and his peers lived in a virtually unpoliced financial world. Today's rich live in a much different environment, but scandals such as the Enron and WorldCom debacles and the bloated salaries of some corporate CEOs create the sense that those at the top are not living by the same rules as everybody else.

Yet government has responded to the scandals with tighter regulation by the U.S. Securities and Exchange Commission and other agencies and measures such as the 2002 Sarbanes-Oxley Act, which establishes stronger corporate accounting and auditing requirements. Some of Jay Gould's buccaneer heirs, such as Enron's Jeffrey Skilling, have been marched off to prison. Stock options, which account for much of the vast increases in pay at the top of corporate America since the 1970s, have come under closer scrutiny, especially the practice of backdating them to artificially increase their value. More than 130 companies are under investigation, and dozens of CEOs and other top corporate executives have already lost their jobs. Compared to the convulsive reforms of the Progressive Era, today's rolling reforms ought to be easier to digest.

Rule #4: Police Your Friends. The case can be made that America's CEOs, with average earnings of $10.5 million in 2005, are underpaid. Many entrepreneurs, real estate developers, and private investors earn more. Steven Spielberg earned $332 million that year, and Jerry Seinfeld made $100 million. Tiger Woods got $90 million. (Nobody seems to mind that the great golfer floats around on his own $20 million yacht, 155 feet long and with a crew of nine.) The average CEO's $10.5 million would be good enough only to earn the 83rd spot in the *Forbes* ranking of celebrity rich, right between *American Idol* host Ryan Seacrest at $12 million and the trio of actress and singer Jennifer Lopez, tennis pro Serena Williams, and celebrity chef Emeril Lagasse at $10 million. The managers of the top 25 hedge funds enjoyed an average compensation of $251 million in 2004.

Yet even within corporate America, the conviction appears to be growing that too many top executives are paid far more than they are worth. Warren Buffett is well known for his criticisms of exorbitant pay. As a member of the board of directors compensation committee at investment bank Salomon, Inc., he voted against bonuses for top executives in 1990 when the company's profits fell. Buffet sits on many corporate boards, but he hasn't been asked to sit on a single compensation committee since. According to The Corporate Library, one of the leading firms that track executive pay, Barry Diller of InterActiveCorp, an Internet conglomerate, was the highest-paid CEO in America in 2005, with $295 million, gained mostly through the exercise of stock options granted in earlier years. (The measurement of executive pay is complicated by the complexity of compensation packages and disclosure rules that still leave some factors unknown; an alternative measure puts Diller's pay at $85 million.) Even at the very top, there are significant gaps between winners and "losers." The number 10 slot on The Corporate Library list is occupied by Valero Energy's William E. Greehey, with $95 million.

In a separate report, *Pay for Success*, The Corporate Library used a number of metrics to identify companies that got especially good value from their CEOs. The 2005 pay for these executives, who worked at companies of very different sizes, ranged from $762,000 to $16 million. Other metrics yield different estimates of justifiable rewards, but all make it apparent that CEO pay at big companies will be measured in millions.

Virtually every effort by activists and government to rein in corporate compensation seems to have failed or backfired. Far from restraining increases, disclosure rules imposed by federal regulators in 1993 apparently juiced executives' competitive instincts by revealing what their rivals were making and giving them leverage to negotiate bigger compensation packages, according to a *Wall Street Journal* review of efforts to contain executive pay. Stock options, once promoted by activists as a way to tie pay more closely to performance, quickly became funny money. And now that Sarbanes-Oxley has tightened reporting requirements for options grants, the manna is flowing through new paths. More disclosure requirements and negative publicity may help, but short of draconian measures, it will be up to corporate shareholders who pay CEO salaries and the boards of directors that set pay levels—boards heavily populated by top executives from other companies who have often taken

chummy approaches to the task—to demand closer links between pay and performance at the top.

Rule #5: Stay Competitive. Escalating pay for CEOs is only the most controversial aspect of the larger phenomenon of swiftly growing income gains for those at the top. What accounts for the change? One cause is the rapid emergence of new industries on a scale not seen since Jay Gould's era, which is suddenly creating a handful of big winners. In the 19th century the industries were steel, railroads, and other manufacturing mainstays; today they are computers, software, and other knowledge-based sectors.

THE TOP ONE PERCENT of households used to claim 40 percent of the nation's private wealth; now their share is half that.

What is different this time is that the competition for talent and markets is global in scale, raising both the stakes and the rewards. As Robert H. Frank and Philip J. Cook argue in *The Winner-Take-All Society* (1995), the new order allows economic winners to increase their gains—the crack heart surgeon whose clientele was once limited to his home city, for example, now draws patients from all over the world who are willing to pay more for the best care. In this hypercompetitive world, many of the old informal constraints on high earners have vanished. Corporations are increasingly reaching outside to hire "star" CEOs rather than promote from within—and paying more to get them. And since for many high fliers the race is as much about getting better toys than their peers as it is big paychecks, the collapse of old constraints has given their competitive zeal free rein. The Old Money ethos that frowned on ostentatious displays of wealth is dead, freeing the new rich to race harder for showy tokens of their success—mansions in Aspen, private jets, and all the rest—and for the money to pay for them.

These are, in many ways, positive developments. Talents given wider scope are a benefit for all. Critics decry the fact that by one estimate today's high-level executives make 170 times more than the average worker, compared with 68 times more in the 1940s, as if the post–World War II years were the age of the golden mean. Yet the 1950s and '60s were still a time when you could more or less forget about joining the elite if your last name was Blumenthal, Flanagan, or Gugliemo, much less if it was prefaced by a "Miss" or "Mrs." The U.S. economy was a mighty engine, but it was largely insulated from outside competition, and much of American society in those postwar decades was still organized as if for the great military campaign it had recently completed, with individuals slotted into their appropriate roles in the great industrial corporations: Ford, General Motors, DuPont. Ruling over it all in sublime self-confidence was the WASP elite, whose sons progressed easily from prep schools to the top institutions in American society. In 1952, 90 percent of all sons of Harvard men who applied to the university were accepted. The average verbal SAT score of the freshman class was a modest 583 out of 800. The constraints that kept money in check came at a significant price.

The great shift in American economic life since the 1970s has been accompanied by a second salutary effect: a surprising decline in the concentration of wealth. In the early 20th century, the top one percent of households claimed 40 percent of the nation's private wealth; now their share is about half as large, according to Emmanuel Saez. For the most part, this decline is a product of the breakup of many 19th-century fortunes under the impact of the Great Depression, World War II (which saw many old industrial firms wither as the federal government channeled its spending to huge companies with more than 10,000 employees), and high levels of taxation that slowed the accumulation of new wealth. As a result,

the top of today's wealth pyramid is dominated by the "working rich." This is another reason why contemporary wealth disparities don't have quite the same bite. It would be harder to accept the spectacle of grandees winging around the world in private jets if their money were simply an accident of birth.

Yet the diminution of inherited wealth could be only a temporary phenomenon, as today's winners entrench their positions and create privileged positions for generations of their heirs. For a society already struggling to widen pathways of upward mobility such as elite higher education and to control the role of money in the political process, a permanent moneyed establishment could be disastrous.

War and depression do not seem like good antidotes. What about taxation? Saez's research shows that the top 0.1 percent of earners have greatly increased their (pretax) share of income in Canada and Britain as well as the United States—but not in the high-tax nations of France, the Netherlands, and Switzerland. He suspects that high marginal tax rates helped keep those incomes in check—a person handing over a big chunk of every pay increase in taxes doesn't have a big incentive to ask for more. Saez acknowledges flaws in his theory. Canada didn't have deep tax cuts of the kind Britain and America did, and even in those two countries the timing of changes in income and tax rates doesn't correspond very closely. And, of course, there is the golden goose question: The three Continental economies have not kept pace with the English-speaking trio.

In any event, taxes designed simply to restrain the incomes of CEOs and movie stars are not likely to attract much public support in the United States. Karlyn H. Bowman of the American Enterprise Institute has gathered poll data on such questions going back to the 1930s. In 1939, when the nation was still in the grip of the Great Depression, a Roper poll for *Fortune* magazine asked, "Do you think that our government should or should not redistribute wealth by heavy taxes on the rich?" Only 35 percent answered "should," while 54 percent said "should not." Dozens of surveys asking the question in different ways over the years have revealed a hard core of about a third of the population that favors soak-the-rich taxes.

Public attitudes toward estate taxes are even more revealing. It is a wonder why Republicans needed to dream up the "death tax" label in the unsuccessful campaign to repeal them, since they have been far and away the most unpopular taxes in the United States. Americans cherish the belief that they or their children have a decent chance of amassing the kind of wealth that would be taxed away. A Gallup/CNN/*USA Today* survey seven years ago asked: Would you personally benefit if the tax on estates over $1 million were eliminated? Seventeen percent said they would and 43 percent said they would not. A hopeful 39 percent answered "Don't Know."

Americans will continue to debate the upsurge in wealth, but despite occasional gusts of soak-the-rich rhetoric, most of the arguments won't likely be about something as abstract as reducing the share claimed by the top one or 10 percent. People aiming to reduce federal deficits and others seeking to expand government programs will want the rich to pay somewhat more. Conservatives seeking to restrain the size of government and others convinced that higher taxes will reduce economic growth will oppose them. There will be compromises. Americans do not see globalization in the same light as many saw late-19th-century industry capitalism—a zero-sum game that benefits the rich at the expense of the rest. Vigorous policing of the executive suites; efforts that increase economic mobility; and policies that reduce the insecurities caused by outsourcing, health care costs, and rapid changes in the job market will help keep tensions in check.

Farther off in the distance is the specter of a wealthy class that creates for itself the kind of entrenched position once enjoyed by the WASP establishment. As the WASPs learned, an elite that frustrates popular aspirations for success will find it hard to sustain itself. Preserving upward mobility and social fluidity is a problem to be reckoned with by broadening the avenues to opportunity and ensuring that today's winners continue to be exposed to the withering forces of competition at home and abroad. The chief antidote to an entrenched elite of the wealthy is more of the hypercompetition that lifted them to the top of the heap in the first place. ■